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A New Model for Banks? How Hedge Funds Got It Right on Risk

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LONDON -- When you think about future financial stability, ask yourself this contrarian question: Why is it that the nefarious hedge funds, supposedly the bad boys of the financial world, came through last year's crisis in relatively good shape?

It was widely predicted that these funds, which invest huge pools of capital for their wealthy clients, would have a crackup like that of the regulated banks. Some did go under, but the general catastrophe never happened. Why? The answer partly is that the hedge funds still had to live by the old capitalist rules: There was no lender of last resort to bail them out. So these unregulated managers turned out to be more cautious than the regulated ones.

There's a perverse lesson here, which has been noted by some of the finance ministers and central bankers who gathered for this week's Group of 20 meeting in Pittsburgh. If you want better behavior from bankers, then make their financial incentives more like those in the hedge fund world -- where managers have "skin in the game" and their net worth is tied to their long-term performance.

Hedge fund managers make too much money relative to their social utility. I wish their rewards were a bit closer to those of, say, schoolteachers. But at least the unregulated traders have to live in a profit-and-loss system. They are "regulated," in effect, by their investors. If they screw up, they don't get to join Citibank and Bank of America in the queue for a taxpayer bailout.

"The system we have created for big banks is a travesty," says one

European central banker who has been active in the G-20 debates. "You can mismanage your business, and if it goes wrong, society pays the bill. We need to find a way where bankers know they can fail."

To examine why the hedge fund industry didn't blow up last year, let's look at some numbers gathered by a group called HedgeFund Intelligence. They show that U.S.-based funds suffered an average loss of 12.7 percent in 2008. That's a sharp hit, but it's nothing like the 38.5 percent decline for the Standard & Poor's 500. Losses for banks were much higher still.

Some hedge funds got pounded, to be sure, because they made bad bets or because investors decided to pull out their money. Nearly 500 funds disappeared last year, according to HedgeFund Intelligence, but that's out of a universe of roughly 7,000.

The salvation of the hedge fund industry was that its existential crisis came 10 years earlier, with the 1998 implosion of Long-Term Capital Management. After that fund went down, the hedge funds' lenders got nervous and tightened their standards. As a result, in the past decade the supposedly go-go hedge funds were actually less leveraged than many banks.

To see how the borrowing mania hit banking, look at confidential numbers for big Swiss banks, once renowned for their caution. Debt ratios at the two largest banks rose in the past dozen years from 90 percent to 97 percent -- meaning that they had 97 Swiss francs of borrowed money for every three francs of capital. In the banks' trading accounts, the use of borrowed money was even greater. One study calculated that by 2006, the traders at big Swiss banks were borrowing 400 times their capital -- which was about 100 times as high as the leverage ratio of a typical hedge fund.

In Pittsburgh, the G-20 nations are beginning the process of putting the financial house back in order. My worry is that the politicians will put too much faith in regulatory supervision -- which demonstrably didn't do the job in the run-up to the 2008 crash. The best restraint is old-fashioned market discipline, in which financial traders know that they, personally, will lose a ton of money if they take risky bets that don't pan out.

Make the financial industry pay for its mistakes. That's the idea behind the best of the Obama administration's reform proposals: If banks issue securities backed by mortgages, say, then require them to hold some of that paper so that they will bear some of the losses. When banks devise

compensation schemes for their top executives, urge their boards to adopt the hedge fund practice of "claw-back" payments so that one year's big gains will be reduced by the next year's big losses. The underlying idea, says one White House official, is to "fight short-termism."

Socialism for rich bankers is such an outrage. Profit and loss -- what a concept!